STATE STREET GLOBAL ADVISORS

2018
Global Market Outlook

Step Forward,
Look Both Ways

The Macro Picture

Economic Outlook— Growth Broadens, Returning to Trend

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Growth Back on Trend

Global growth more evenly distributed and expected to return to historical trend rate

Positive Signals

Improvements evident in global trade, business investment and corporate earnings, as well as consumer confidence

Potential in Emerging Markets

We recommend a selective approach to EM countries, as few have achieved structural reforms to sustain stable growth, and technology could undermine comparative resource and labor advantages

More than 10 years after the first tremors of what would become the global financial crisis (GFC), we expect global growth will finally return to its trend rate of 3.7% in 2018. The real question for us is whether this is more than just a cyclical upswing.

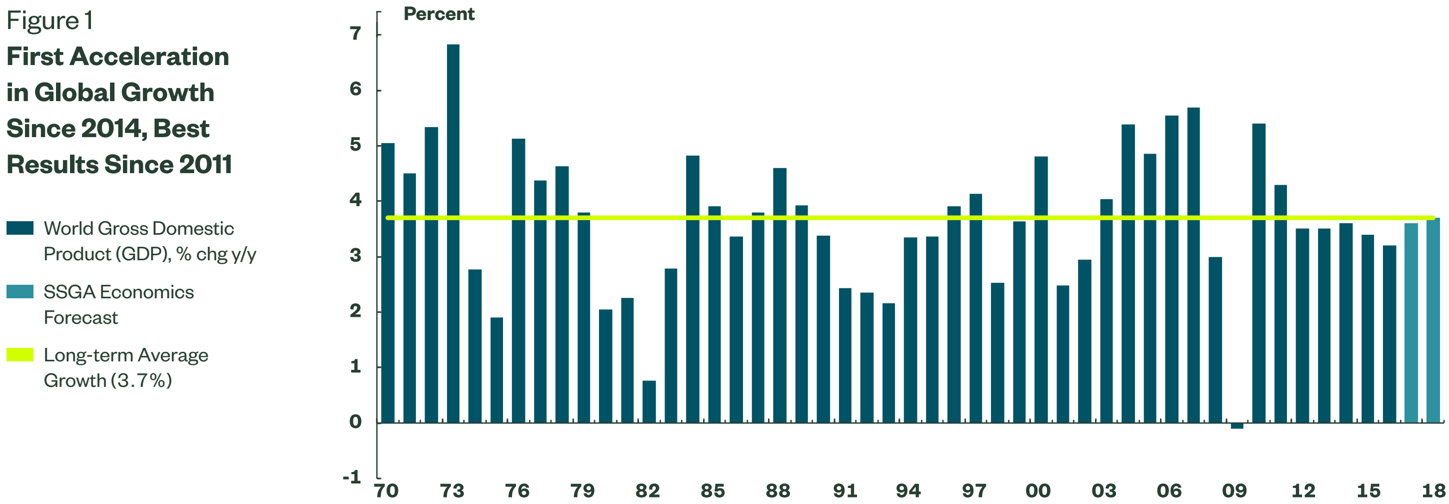
Recovery from the GFC has been unusually long and sluggish, though not inconsistent with what Reinhart and Rogoff have documented following previous credit-induced financial crises.

The improvements we saw last year were quite widespread. Brazil and Russia finally emerged from deep recessions, India remained vibrant and the long-awaited Chinese slowdown failed to materialize. Meanwhile, the recovery of oil prices boosted the US and Canada, fiscal stimulus supported Japan, and domestic demand buoyed the eurozone.

Still, for us this is a relatively modest cyclical upswing rather than a genuine breakout to the upside, especially as a combination of deteriorating demographics and slower productivity growth means that the sustainable or potential growth rate of advanced economies remains subdued.

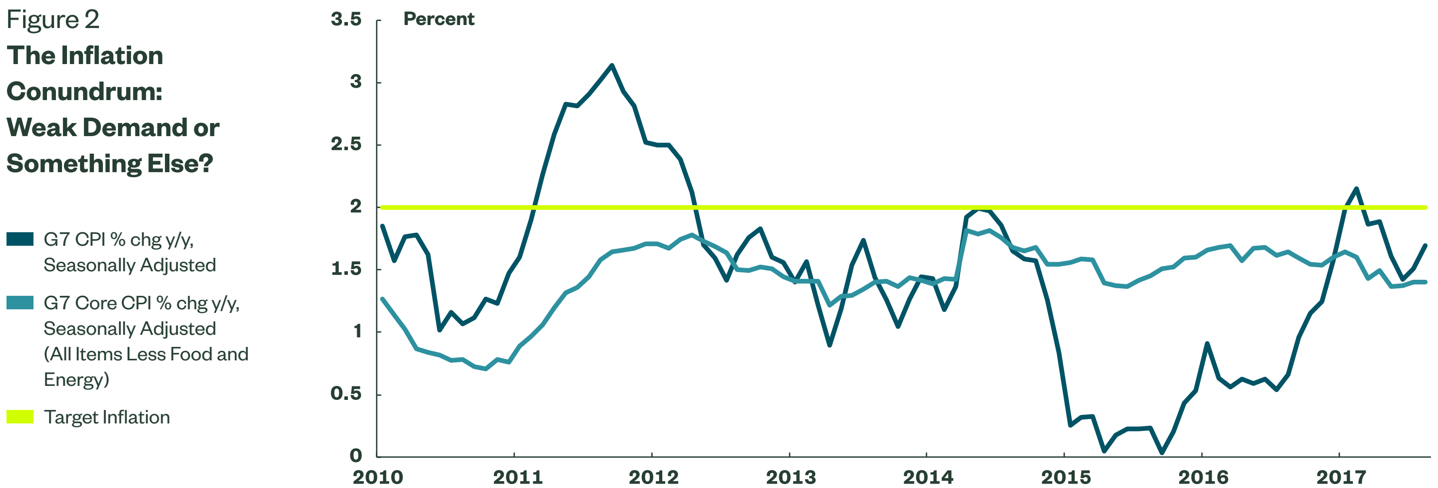
Inflation, too, remains muted. Since mid-2014, oil prices have driven the evolution of inflation. After a slight uptick in 2016 and 2017, we expect inflation to stabilize in 2018 as oil prices fail to move any higher.

Figure 1
First Acceleration in Global Growth Since 2014, Best Results Since 2011



Source: IMF, SSGA Economics as of October 17, 2017. Past performance is not a guarantee of future results. Forecasts (the lighter shaded bars to the far right) are based upon estimates and reflect subjective judgments, assumptions, and analyses made by SSGA. There can be no assurance that developments will transpire as forecasted and that the estimates are accurate.

Figure 2
The Inflation Conundrum: Weak Demand or Something Else?



Sources: Macrobond, SSGA Economics, OECD (Organization for Economic Co-operation & Development) as of September 19, 2017. Past performance is not a guarantee of future results.

Monetary Policy Converging

While the Federal Reserve is ahead of other central banks in normalizing monetary policy, we expect more central banks to join in this year. We anticipate three rate hikes in the US as well as in Canada. After raising rates once in 2017, the Bank of England is likely to hike once more this year. The Reserve Bank of Australia should begin a gradual tightening cycle, moving once in the first half, and once in the second. Meanwhile, our view is that the European Central Bank (ECB) will leave rates unchanged but continue to taper asset purchases. We anticipate the Bank of Japan will remain the outlier, with no changes at all, because inflation remains so far below target.

US: Fiscal Cliffhanger

The outlook for the US depends critically on fiscal policy. In the absence of any stimulus, we would still expect a slight acceleration of growth from 2017's projected 2.2% because of ongoing rebuilding from the damage caused by the hurricanes, and gathering momentum in the mining and manufacturing sectors. However, the overall improvement depends on the size and timing of any federal tax cuts and/or spending programs.

The Republicans have proposed cutting the statutory corporate tax rate to 20%, establishing just three personal income tax brackets of 12%, 25% and 35%, and lowering the rate on pass-through income to 25%. They also seek to abolish the alternative minimum and estate taxes, and eliminate itemized deductions except for mortgage interest costs and charitable contributions.

Because the cost of these cuts is so high at $2.4 trillion over 10 years (according to the Tax Policy Center), we expect a more modest package will prevail, worth around $1.0 trillion (or about 0.5% of GDP) over the next decade. This could boost growth to 2.7% in 2018, lowering the unemployment rate even further, to 4.0%.

Not surprisingly, consumer spending and business fixed investment remain the major drivers of growth, as they benefit directly from lower personal and corporate tax rates. In the longer run, the personal tax provisions will likely have to sunset (like the Bush tax cuts of the early 2000s) in order to comply with the Byrd rule—the requirement that any changes be deficit neutral in the year after the budget resolution window closes. But the Republicans will almost certainly seek to make the changes to corporate taxes permanent by making them deficit neutral (which probably means the corporate rate will end up at 25% rather than 20%).

Europe: Surprising to the Upside

One of the biggest positive growth surprises of 2017 was Europe. Moreover, the quality of growth has been good, with inventories well behaved and domestic final sales accounting for almost all of the growth. For 2018, we expect a slight moderation of growth to 1.9%, reflecting the recovery of oil prices, appreciation of the euro and the impending tapering of the ECB's asset purchase program.

The eurozone's big three economies continue to diverge. Germany has boomed for some time, with the unemployment rate falling steadily to just 5.6% in September 2017 (the lowest since reunification). France has improved of late, but unemployment is still at an elevated 9.2%. And Italy has really struggled, with the labor market improvement stalling in 2016 and keeping the unemployment rate at 11.2%.

The UK economy has fared better than most had dared hope in the immediate aftermath of the Brexit referendum. Moreover, it does not appear that conditions in either the labor market or the economy as a whole are about to take an abrupt turn for the worse. We expect growth of 1.6%, given an anticipated transitional agreement with the EU, which limits any weakening of fixed investment.

Japan: Fiscal Stimulus to Boost Growth

Abenomics may finally be having some effect, at least on economic growth. With the economy threatening to falter in the middle of 2016, the government decided to fire another "arrow," introducing a fiscal package containing about ¥7.5 trillion of new (so-called fresh-water) spending that directly stimulates the economy. In 2017 industrial production broke to the upside, retail sales picked up and GDP rose 0.6% in the second quarter.

We expect the economy to advance 1.6% this year, the best performance since 2013. But we think that represents the high-water mark. With potential output running at only 0.7% a year, the labor market keeps tightening, eventually limiting employers' access to suitable labor, and constraining growth. Indeed, there are already 152 job vacancies for every 100 applicants.

Emerging Markets: The End of Hurricane Season

Last year we saw the emergence of synchronized global growth as emerging markets (EMs) joined the upturn. This year, we think EM growth will likely quicken to a five-year high of 4.9%, assuming China focuses on reining in debt gradually and Brazilian politics do not derail either the (hesitant) progress on structural reforms or the budding cyclical recovery.

Politics aside, four fundamental factors should sustain EM growth over the next year: a pick-up in global trade; higher commodity prices; a weaker US dollar; and monetary policy shifting to a pro-growth agenda. While 2016 saw growth in global trade volumes grind to a near standstill, last year saw a sharp reacceleration to six-year highs, providing a boon to trade-dependent EMs.

Stronger global growth has also been accompanied by higher commodity prices. Even if we don't see another leg higher from here, the fiscal healing from higher commodity prices will be a big boost for EM commodity exporters well into 2018. Contrary to expectations, last year's weakening of the US dollar has alleviated pressures on EM exchange rates and inflation. The switch has allowed monetary policy to focus on a more pro-growth agenda rather than battling inflation, as evidenced by repeated interest rate cuts in Russia and Brazil, for instance.

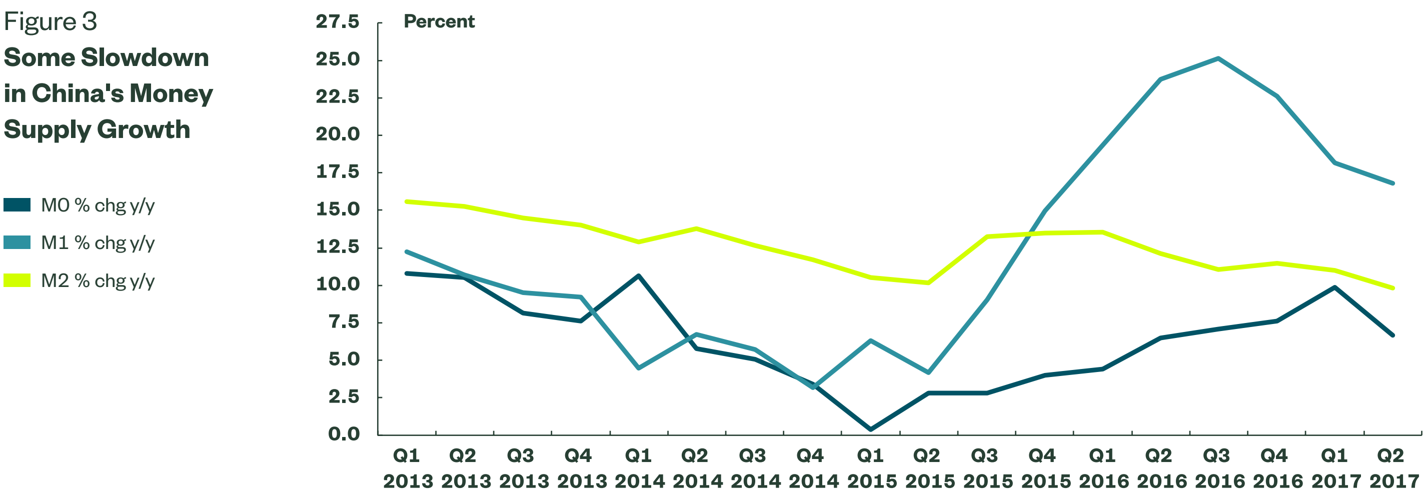
Longer term, emerging markets still have a demographic advantage, considerable room for catch-up growth and, relatively speaking, greater potential for policy stimulus. However, technological changes could end up undermining their comparative advantages of resource abundance and cheap labor. Moreover, few EM countries have achieved the structural reforms that can sustain high and stable growth far into the future. We highlight the differentiated conditions across these countries and recommend a selective approach. But we also advise against mood swings: emerging markets should inspire neither gloom nor giddiness, though recent strong inflows suggest a hint of party mood in the air. We say drink responsibly.

China: Orderly Deceleration

We believe both domestic macro signals and international dynamics suggest only a modest deceleration in China's growth rate to 6.4% in 2018 from 6.8% last year. While there has been growing acknowledgement among Chinese policymakers of risks associated with excessive indebtedness, a sharp slowdown in credit growth following last fall's party Congress seems unlikely. It is important to distinguish between riskier types of lending such as shadow banking, and the more traditional lending channels, which are still seen as fundamental to growth. Thus, we believe the upcoming "tightening" might be less draconian than feared and involve a reorientation in the sources of credit rather than a substantial cut in credit availability overall.

The central bank's decision to selectively reduce reserve requirement ratios for certain bank lending activities starting in January is telling. And while the threat of US trade protectionism is still very real, the immediacy of the North Korea crisis may drive a more collaborative and less confrontational US-China bilateral relationship in coming months.

Figure 3
Some Slowdown in China's Money Supply Growth



Sources: Macrobond, SSGA Economics, People's Bank of China as of October 2017.
Past performance is not a guarantee of future results.

India: Short-Term Pain for Long-Term Gain

While the demonetization move in late 2016 and the introduction of the Goods and Service Tax (GST) in 2017 were initially painful, we could begin to see positive effects as early as this year, when we anticipate a growth pick-up to about 7.5%. India needs to engineer a shift away from excessive reliance on domestic consumption toward more investment and exports. At the moment, this smaller reliance on global demand shields it from downside risks from a potential trade conflict with the United States. However, this by no means offsets the much bigger problems of low productivity, poor infrastructure and lack of international competitiveness.

Prime Minister Narendra Modi's recent electoral successes strengthen his mandate and could accelerate progress with the sort of structural reforms that might eventually deliver not just high growth, but a transformation that could propel India into a global manufacturing powerhouse.

Russia: Turning the Corner

Russia's economic recovery turned a corner last year, with the recession ending and growth firming to 1.5%. This year should be at least as good. Russia is a major beneficiary of higher oil prices, it has experienced a powerful domestic disinflationary trend that means real household incomes are no longer being squeezed and its central bank has gradually embraced a more accommodative policy stance. The recovery in oil prices is also supporting public finances, if not yet triggering much of an investment revival.

After two rate cuts in 2017, we do not think the easing cycle is over given that the even sharper deceleration in inflation still leaves the real policy interest rate above 5.0%, which is among the highest across large EM economies. However, the lack of economic diversification and challenging demographics remain key drags on potential growth over the long term.

Brazil: The Rollercoaster

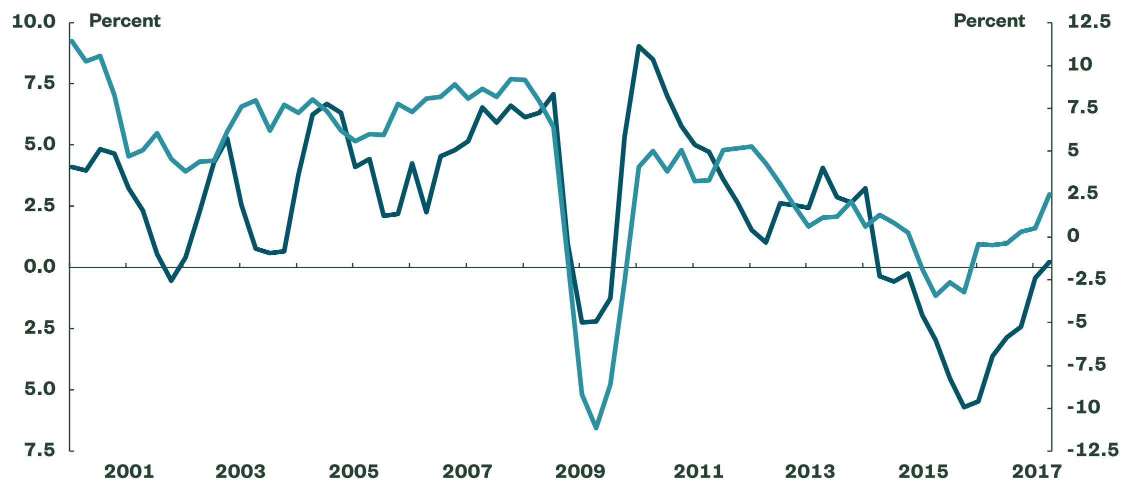
Perhaps nowhere have politics been so extraordinarily central to the economic outlook as in Brazil. With presidential elections scheduled for October 2018, the country's political rollercoaster does not look likely to slow any time soon. Risks of failure are high as are the potential rewards of success.

Uncertainty is great and the range of outcomes very wide. Still, we expect President Temer to serve out his term and sufficient reform progress to keep capital inflows steady enough to support the currency and disinflation. If monetary policy easing continues, then we expect growth to accelerate to 1.7% this year from 0.5% in 2017.

Figure 4
Growth Turning the Corner in Hardest Hit Emerging Markets

Brazil Real GDP, % chg y/y, lhs

Russia Real GDP, % chg y/y, rhs



Sources: Russian Federal State Statistics Service (Rosstat), Brazilian Institute of Geography & Statistics (IBGE) as of September 19, 2017. Past performance is not a guarantee of future results.

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Glossary

Consumer Price Index (CPI)
A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. Changes in the CPI are used to assess price changes associated with the cost of living; the CPI is one of the most frequently used statistics for identifying periods of inflation or deflation.

Core Consumer Price Index (CPI)
A measure of the CPI that excludes goods exhibiting price volatility, such as food and energy.

Gross Domestic Product (GDP)
The monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Group of Seven (G7)
An informal bloc of industrialized democracies—Canada, France, Germany, Italy, Japan, the UK, and the US —that meets annually to discuss issues such as global economic governance, international security, and energy policy.

Target Inflation
A monetary policy regime in which a central bank has an explicit target inflation rate for the medium term and announces this inflation target to the public.

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IBGE-4367 Exp. Date: 30/11/2018